Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
AT&T Corp.	)	
	)	RM No. 10593
Petition for Rulemaking to Reform	)	
Regulation of Incumbent Local Exchange	)	
Carrier Rates for Interstate Special	)	
Access Services	)	

REPLY COMMENTS OF WORLDCOM, INC.

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EXECUTIVE SUMMARY

Initial comments showed widespread agreement that the RBOCs maintain a monopoly over most of the routes where there is demand for special access services. That monopoly has allowed them to continue to impose special access prices that are grossly excessive. The Commission's pricing flexibility framework has resulted in the premature and excessive deregulation of these services, despite the fact that the RBOCs face competition on only a small minority of the routes where there is demand for special access.

The RBOCs and their trade association are the only defenders of the existing regime. They claim that the "market" for special access is wildly competitive. They deny that they possess market power over special access. They claim that AT&T could not show that special access rates allow the RBOCs to make excessive returns at the expense of their customers and the national economy. They are wrong in each instance.

The RBOCs rely almost entirely on a declaration submitted by Alfred E. Kahn and William E. Taylor. That declaration appears to be based on the misconception that competitive carriers enter and compete in MSA-wide markets for special access. In fact, they do not. Competitive carriers enter and compete one route at a time. The presence of competition on one route does nothing to alleviate the ILECs' monopoly over all other routes.

As shown in the attached declaration of Dr. Michael D. Pelcovits, in the real world pricing flexibility allows the ILECs to pursue exclusionary pricing strategies intended to deter additional competitive entry by denying new entrants the ability to achieve the minimum scale necessary to justify the deployment of facilities on new

routes. The Commission must address this significant threat to competition by re-imposing price caps, at just and reasonable rates, on routes where the ILECs maintain an effective monopoly.

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REPY COMMENTS OF WORLDCOM, INC.

I. Introduction

Initial comments filed in this proceeding showed widespread agreement that the Commission's pricing flexibility framework has resulted in the premature and excessive deregulation of incumbent local exchange carrier (ILEC) special access prices. Many parties urged the Commission to roll back its framework for ILEC special access pricing flexibility.[1] Others decried the ILECs' use of exclusionary pricing to deter competitive entry.[2] End user customers emphasized the harmful consequences of grossly excessive special access prices on their businesses.[3] Predictably, the only comments in support of the existing regime came from the ILECs and their trade association.

According to the ILECs, AT&T did not and could not show that the ILECs' grossly excessive returns on special access demonstrate that the Commission's policies have failed.[4] The ILECs again attack state-adjudicated, cost-based TELRIC rates as

[1] *See, e.g.,* Cable and Wireless USA, Inc. Comments at 5.
[2] *See, e.g.,* Arch Wireless Operating Company, Inc. Comments at 4.
[3] *See, e.g.,* Ad Hoc Telecommunications Users Committee Comments at 2.
[4] *See, e.g.,* SBC Opposition at 19.

steeply discounted, below cost, and failing to account for significant joint and common costs.[5] They again claim that special access competition is widespread, robust, and thriving.[6] They defend the Commission's pricing flexibility framework, claiming that it deregulates ILEC special access services only in markets where competitive entry has already occurred.[7] They deny that pricing flexibility allows them to manipulate special access rates to impede competition,[8] although one of their economists admits that monopolists can engage in exclusionary pricing. They claim that, prior to pricing flexibility, special access rates were artificially depressed and needed to be raised, that the rate increases under pricing flexibility have contributed to an explosion in deployment of competitive facilities,[9] and that those increases result from rapidly growing demand, not ILEC market power.[10] Yet they simultaneously deny that special access prices have increased overall.[11] Finally, they invoke the apparently never stale ILEC tactic of claiming that a policy change that reduces ILEC revenue will cause the sky to fall, effectively ending their ability to invest in the network and producing a devastating impact on allegedly exemplary service quality.[12]

This is nonsense on steroids. The ILECs have badly mischaracterized the facts, and have provided no evidence to show that their returns on special access are in fact reasonable. In these reply comments, WorldCom, Inc. ("WorldCom") refutes the ILECs' attempts to defend a status quo that allows them to earn grossly excessive returns on special access, while also deterring competitive entry. The resulting harm to competition

[5] *Id.* at 27; BellSouth Comments at 9-10.
[6] *See, e.g.,* SBC Opposition at 10-15.
[7] *Id.* at 9.
[8] *Id.* at 28.
[9] Verizon Opposition at 25.
[10] Kahn and Taylor Declaration at 13.
[11] *See, e.g.,* SBC Opposition at 24.

and deadweight loss to the national economy are monumental. The Commission should roll back pricing flexibility and bring ILEC special access services under a regulatory framework that protects customers and competitors from the ILECs' exercise of market power. WorldCom urges the Commission to commence a rulemaking to establish such a framework and, in the meantime, grant the interim relief sought by AT&T.

II. The Kahn and Taylor declaration fails to rebut the showing made by AT&T, WorldCom and others.

Alfred E. Kahn and William E. Taylor submitted a declaration on behalf of BellSouth, Qwest, SBC, and Verizon. That declaration is central to the oppositions filed by each of those companies. However, that declaration falls far short of rebutting the case made by AT&T in its petition, and by WorldCom and other parties in initial comments.

A. Special access competition is not as robust as Kahn and Taylor suggest.

Kahn and Taylor begin with a brief history of special access competition. The nature and extent of special access competition is in fact the central issue. Effective competition, where it exists, protects the public interest far better than regulators. Kahn and Taylor's key claims[13] are that: competitive fiber route miles have increased greatly since 1990; competitive fiber access networks now exist in a host of metropolitan statistical areas ("MSAs"); competitive providers receive 30 percent or more of special access revenues; and the dominance of interexchange carriers ("IXCs") in the market for

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[12] Verizon Opposition at 30.

[13] Kahn and Taylor rely heavily on the so-called "UNE Fact Report," to support their arguments. That piece of advocacy has been shown elsewhere to be entirely unreliable. *See, e.g., In the Matter of Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* CC Docket No. 01-338, AT&T Reply Comments, Reply Declaration of C. Michael Pfau (filed July 17, 2002). For example, in estimating the extent of competitive access networks, the "Fact Report" counts as competitive, services that are in fact purchased from ILECs. The "Fact Report" is unreliable as a source of facts.

large business customers demonstrates that IXCs can successfully compete in competitive retail markets using some combination of their own facilities, those of other competitors, and the regional Bell operating companies ("RBOCs").[14]

Their high-level review of special access competition provides little basis for concluding that special access services generally are competitive. Kahn and Taylor make no attempt to discern any patterns in the manner in which competitive networks have been deployed, and the manner in which the ILECs have responded to that deployment. Had they done so, they would have reached very different conclusions about special access competition.

Whatever market share competitive carriers may possess in an imaginary nationwide market for special access is not relevant to the nature of competition in real world special access markets. The ILECs are the only providers of ubiquitous special access facilities. Competitive access providers neither build nor sell special access services on a nationwide basis. These providers face a multitude of case-by-case decisions about whether to construct individual point-to-point routes for special access services. Competing for one customer in this "market" does not imply the ability to compete for the special access business of any other customer.

As stated above, the ILECs offer high-capacity services over their own fiber and copper distribution networks to every address in the country where there is demand for such services, and they also have the ability to use large portions of their networks to carry not only special access traffic but also local and switched access traffic. Competitive access providers deploy fiber in areas where teledensity is high, and "light"

[14] Kahn and Taylor at 3-4.

network nodes at those locations where there is substantial demand for special access services.

A result of this is that competitive access facilities have been deployed to only a small fraction of the end user locations where there is demand for one or more DS-1s.[15] This holds equally true for ILEC wire centers.[16] There are no providers of competitive transport to the vast majority of ILEC wire centers. Only a tiny fraction of ILEC wire centers have 3 or more competitive providers available.[17]

The Commission might wonder how this is consistent with Kahn and Taylor's claims about the "market share" of competitive special access providers. The answer is that the "special access market" to which they refer is in fact an aggregation of a very large number of point-to-point markets. The densest routes, such as routes between IXC POPs and serving wire centers, represent a disproportionate share of all special access services. Not coincidentally, those are the very routes where competitors are most likely to deploy facilities.

If instead of aggregating special access into a single and highly misleading nationwide market, the Commission focuses on discrete routes or segments where there is demand for special access services, it will find a very different pattern than the uniform, widespread competition suggested by Kahn and Taylor. There is substantial competition for entrance facilities in many metropolitan areas. In those areas, there is also competition for last-mile channel terminations to end users that require OC-n

[15] WorldCom estimates that the ILECs are monopoly of DS-1 or higher special access services to approximately 90 percent of the end user locations where there is demand for such services. *See* October 7, 2002 letter from Ruth Milkman on behalf of WorldCom to Marlene H. Dortch, attached presentation at 7, CC Docket No. 01-338.

[16] Indeed, competitive special access transport is available to less than 10 percent of the wire centers to which WorldCom requires such transport.

connectivity. There is only extremely limited competition for most end user channel terminations at lower bandwidth levels even in the most competitive areas in the country. There are a very small number of ILEC wire centers to which competitive special access providers offer service. While these wire centers undoubtedly represent a disproportionate share of the aggregate demand for special access transport, they do nothing to address the ILECs' monopoly on other special access transport routes.

The ILECs have responded to this uneven pattern of competitive entry in a couple of ways. As described in detail in the attached declaration of Dr. Michael D. Pelcovits, in some instances they have adopted volume and growth commitment plans intended to prevent competitors from achieving the minimum scale necessary to justify deployment of facilities on additional routes.

ILECs have also maintained a form of distance-sensitive pricing for special access which would not be sustainable in competitive markets, and which results in prices being highest on the least contestable routes – exactly the kind of pricing behavior that a rational monopolist would pursue.

A typical special access circuit consists of a number of rate elements. The channel terminations at the customer end and for the entrance facility between the IXC and ILEC network are flat-rated. However, for the interoffice transport piece between the two ends of the circuit, there is a per-mile charge as well as a flat-rated charge.

It is remarkable that special access continues to include significant distance-sensitive transport charges. Such charges have otherwise been competed out of existence in competitive telecommunications markets. The reason for this is that once a

[17] According to the RBOCs' own "Fact Report," competitive transport is available to only 14% of their wire centers, and only 4% of those wire centers are served by three or more competitors.

telecommunications network is built, the cost of providing service on that network is almost entirely related to capacity, and has little to do with distance. Thus, the price of long-distance from New York to Washington is the same as from New York to Los Angeles because the cost of both calls is virtually identical. The distance-insensitivity of modern telecommunications is also seen in the market for dedicated services, except on the input side where competition is still lacking. Thus, the price of a dedicated circuit between New York and Washington is virtually the same as a circuit between New York and Los Angeles, or New York and London for that matter.[18]

Significant, distance-sensitive prices persist in special access because the ILECs see them as a convenient way to impose higher prices on routes that are less contestable. Competitive access providers are able to deploy facilities only to the largest wire centers in the highest density areas. These wire centers are typically quite close to the IXC networks to which many special access circuits are connected. As a consequence, the interoffice distance is generally fairly short. On these routes, per-mile charges are a less significant portion of the total circuit cost. However, as the distance increases for circuits to customers in outlying areas, mileage charges pile up rapidly.

WorldCom undertook a five-state comparison of disaggregated special access charges and cost-based, TELRIC charges for unbundled network elements.[19] That analysis shows that the largest source of the overall difference between UNE and special access prices is found in mileage charges. The average per-mile charge for DS-1 special

[18] The hypothetical application of ILEC per-mile charges to a New York-London private line connection is quite revealing. Verizon's five-year term rate for interstate DS-1 special access transport in New York is a whopping $17.79 per mile. If applied to a New York-London private line DS-1, the resulting circuit would cost over $50,000 per month. The current market rate is closer to $1,000.

[19] *See* October 30, 2002 letter from Ruth Milkman on behalf of WorldCom to Marlene H. Dortch, CC Docket No. 01-338.

access transport in the five states examined of $13.72 is approximately 9 times the corresponding UNE charge of $1.52. The average per-mile charge for DS-3 special access transport of $57.84 is approximately two and one-half times the corresponding UNE charge of $23.35.

The disparity in mileage charges accounts for a significant portion of the overall difference between UNE and special access prices. For example, on a ten-mile DS-1, 80% of the UNE/special access price difference arises from the per-mile charges for transport. Even on a five-mile DS1, mileage charges account for 67% of the difference. Persistent and outrageously high mileage charges are persuasive evidence of the ILECs continued monopoly on most special access routes.

Kahn and Taylor badly mischaracterize the "special access market" as competitive by ignoring the actual pattern of competitive entry and competition. The uneven pattern of competitive entry has produced substantial competition on low-mileage, high-demand routes in metropolitan areas. The ILECs have responded with pricing behavior that is intended to deter additional competitive deployment, while at the same time ensuring that prices are highest on the least contestable routes. The Commission must remedy this situation by adopting a regulatory framework that relaxes regulation only on the actual routes where competition exists, and imposes price caps on the routes where they maintain a monopoly.

B. The Commission's pricing flexibility triggers are not a reasonable proxy for competitive deployment.

In its initial comments, WorldCom demonstrated a number of infirmities with the Commission's pricing flexibility triggers.[20] In their declaration, Kahn and Taylor claim

[20] WorldCom Comments at 7-12.

that those triggers are reasonable.[21] They are wrong. They fail to come to terms with the fact that in the real world, competitive facilities are deployed on point-to-point routes, to which an MSA is no more relevant than a city, a county, a state, or the entire country.

Kahn and Taylor claim that:

> [the Commission's pricing flexibility rules] tailor the degree of pricing flexibility to the geographic differences in the rate at which CAPS, IXCs and CLECs invest and build their own facilities – specifically to the proportion of wire centers in an MSA in which competitors have made sunk investments in their own facilities. The presence of such investments indicates the need for pricing flexibility because it shows that – *in the wire center in question* -- the market is open and entry barriers are sufficiently low that some firms are actually investing in sunk assets.[22]

Kahn and Taylor appear here to recognize that competitors enter the market and deploy special access facilities on a route-by-route basis. They acknowledge that the portion of the market that is "open" is the individual wire center where competitors have deployed facilities. Yet, in the very next paragraph they say that "[e]ntry in one wire center in an MSA was an effective trigger for competition throughout the MSA because carriers enter the market on an MSA basis and special access customers are large, sophisticated businesses with bargaining power sufficient to prevent the exercise of ILEC market power in parts of the MSA in which competitive facilities are absent."[23] This is a complete non sequitur.

Kahn and Taylor already acknowledged that competitive carriers do not enter the special access market on an MSA-wide basis, and instead enter by deploying facilities to individual wire centers or buildings. MSAs are extremely large geographic areas that are defined with respect to population. Competitive telecommunications carriers never enter

[21] Kahn and Taylor at 4.
[22] *Id.* at 5 (emphasis added).
[23] *Id.* at 6.

the special access market on an MSA basis. Instead, they deploy facilities to a limited number of buildings and wire centers where there is sufficient demand for their services.[24] The presence of such facilities on a finite number of routes in an MSA does not diminish the ILECs' monopoly over access to the vast majority of buildings or wire centers where there is demand for special access services. Kahn and Taylor provide no support for their novel claim that special access customers do not need protection from the exercise of ILEC market power since they are large and sophisticated. Nor could they. Large, sophisticated businesses possess no talisman against the exercise of market power by monopolists. Indeed, WorldCom frequently asks the ILECs to lower their special access rates to more reasonable levels. So far at least, its requests have fallen on deaf ears.

C. ARMIS data provide relevant information on ILEC special access rates of return.

In its petition, AT&T presented ARMIS data on ILEC special access rates of return to support its argument that the ILECs are overcharging their customers for special access services. Kahn and Taylor claim that these data provide no basis for concluding that the ILECs possess market power over special access. They argue that the cost allocations used to generate ARMIS data render any calculation of a rate of return meaningless.[25]

In fact, the vast majority of the costs of special access are directly assigned rather than allocated. According to the data reported in the ARMIS 43-04 report, 90 percent of the total telephone plant in service assigned to special access is directly assigned. Since

[24] WorldCom has found that even in the most competitive areas in the largest MSAs, alternative facilities have been deployed to only 11% of the locations where there is demand for special access service.
[25] Kahn and Taylor at 7.

the direct expenses associated with this plant are also assigned to special access, almost all the costs assigned to special access by the Commission's allocation rules are directly associated with the provision of special access, not arbitrarily allocated.

D. The margin between special access and UNE rates is relevant to an inquiry into whether the ILECs are overcharging customers.

Kahn and Taylor argue that margins between special access prices and TELRIC UNE prices can provide no useful information on whether ILECs possess market power over special access.[26] According to Kahn and Taylor, TELRIC prices are not germane because they represent the hypothetical cost of a perfectly efficient competitor serving the entire market using an optimally-deployed, fully-modern network. They also assert that incremental costs fail to account for common costs associated with multi-product firms like the ILECs. Strangely, Kahn and Taylor make this argument only in the abstract and find no fault with any of the actual UNE rate data that AT&T relied on.

Kahn and Taylor have not identified a single instance in which state-adjudicated, cost-based rates for high-capacity facilities depart substantially from the ILECs' costs. Nor have they identified any high-capacity UNE rates that fail to include an allocation of common costs. In the real world, state commissions have included ILEC common costs in their cost decisions. Accordingly, the Commission should disregard Kahn and Taylor's speculation.

E. Kahn and Taylor ignore changes in special access supply.

Kahn and Taylor suggest that special access price increases between 1996 and 2001 simply reflect an outward shift in the market demand curve for special access.[27] They reason that rapidly growing demand for special access services during that period

[26] *Id.* at 9.

would result in price increases as long as the industry supply curve is not horizontal. They omit the implicit assumption that the industry supply curve must also be constant during the relevant time period. It is extremely unlikely that such a condition applies to special access.

Between 1996 and 2001 the ILECs' expanded use of optical fiber and network equipment greatly reduced their costs of providing special access. As Kahn and Taylor are quick to note elsewhere, new competitors also entered the market and expanded available capacity on routes where they deployed facilities. In these circumstances, the special access supply curve should also have shifted outward. There is no reason to think that the increase in supply generally failed to keep pace with the increase in demand.

Kahn and Taylor also point out that ARMIS data show that the RBOC's average revenue per special access line decreased by 1 percent per year in nominal terms between 1996 and 2001.[28] According to Kahn and Taylor, this shows that there is no evidence of special access price increases. They are once again wrong.

Kahn and Taylor fail to adjust RBOC revenue per line to account for the impact of DSL. If DSL is generally sold at a lower price than other special access products, then its introduction and expansion during the relevant time frame would cause RBOC revenue per special access line to fall, possibly counteracting the effect of price increases for other special access products.

Kahn and Taylor also fail to account for other changes in the mix of special access lines. The special access line counts on which Kahn and Taylor rely are expressed in terms of channel equivalents. An increase in the relative number of DS-3s sold would

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[27] *Id.* at 12.
[28] *Id.* at 15.

increase the special access line counts relied on by Kahn and Taylor, reducing the computed revenue per access line. Since DS-3s contain 28 times the number of lines that DS-1s carry, but do not cost 28 times as much, revenue per line will decline as the proportion of DS-3s sold increases.

More importantly, here Kahn and Taylor ignore the expansion of competitive access services that they elsewhere find so impressive. In most instances, competitive access providers replace only a portion of the service that the ILEC would otherwise provide. For example, they might replace the ILEC's entrance facility or part of the interoffice mileage. In most cases, the ILEC continues to provide the last-mile channel termination and some interoffice transport. Any expansion in special access competition should mean a larger reduction in ILEC special access revenue than in ILEC special access lines. One would expect this to translate into a substantial reduction in ILEC special access revenue per line. The fact that the actual reduction was only 1 percent is strong evidence of the ILECs' ability to maintain revenues despite the deployment of competitive networks.

III. Other ILEC arguments must also be rejected.

The Kahn and Taylor declaration provides no valid defense for the ILECs' excessive special access prices. Nor do other ILEC arguments made in initial comments.

BellSouth attempts to portray pricing flexibility as a tremendous boon for special access customers.[29] BellSouth's evidence is a claim that by the end of 2002 special access customers will have saved up to $9.5 million under contract tariffs. Even if true, this must be seen for what it is – the proverbial drop in the ocean. According to the Statistics of Common Carriers, in 2001 BellSouth earned nearly $2 billion in special

access revenues. Pricing flexibility should be seen as a monumental failure if, in addition to the widely-noted price increases, it generates savings of one half of one percent of total special access revenue for one ILEC.

BellSouth also suggests that the Commission should be unconcerned about the possible impact of anticompetitive access pricing in downstream markets.[30] After all, BellSouth reasons, such behavior would be easily detectable since LEC long distance affiliates are subject to biennial audits. BellSouth apparently did not anticipate that the Commission was about to allow the first of the BOC long distance affiliates to shutter its operations. The Commission's decision to allow Verizon's separate affiliate obligation for New York to expire by operation of law makes BellSouth's argument irrelevant.[31] It will be extremely difficult to detect anticompetitive pricing behavior when there are no separate long distance affiliates.

SBC claims that there is no evidence that the existence of a large network enables ILECs to provide dedicated services to a new customer or new location more quickly than CLECs.[32] This is nonsense. Even assuming that there is sufficient demand for a competitor to justify extending its facilities to a new building, such deployment could take six to nine months, or even longer. In almost every case, the ILEC will already have facilities in place. Despite their well-documented, woeful provisioning performance, the ILECs generally are able to provision a special access line in well under six months.

Verizon makes two additional arguments that also lack any merit. Verizon suggests that, prior to pricing flexibility, special access rates were "artificially depressed"

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[29] BellSouth Comments at 11.
[30] *Id.* at 18.
[31] *See* Public Notice FCC 02-335 (rel. December 23, 2002).
[32] SBC Opposition at 36.

and needed to be raised.[33] As WorldCom showed in initial comments, prior to the implementation of pricing flexibility, the ILECs' costs of providing special access were falling rapidly due to technological change. Meanwhile, the Commission diverted the application of the price caps productivity factor to other access services. Thus, not only were special access prices not artificially depressed, they were in fact artificially inflated.

Verizon further claims that rising special access rates have led to an explosion in investment by competitive providers.[34] However, as the RBOCs so diligently point out elsewhere, most pricing flexibility rate increases have occurred only in the last twelve months. Verizon has not shown any explosion in competitive investment in this limited time during which competitive providers have been constrained by well-publicized limitations on access to capital.

IV. Conclusion

It is clear that the ILECs maintain a monopoly on a substantial majority of the routes where there is demand for special access services. Special access prices are grossly in excess of any reasonable measure of the actual costs of providing the service. Pricing flexibility allows the ILECs to further exploit their monopoly by engaging in exclusionary pricing intended to make it more difficult for competitive special access providers to achieve the minimum scale necessary to justify the deployment of additional facilities. The Commission should act swiftly to remedy this unacceptable situation initiating a rulemaking to reform its regulation of ILEC special access services, suspending all existing grants of pricing flexibility, and granting the interim relief sought by AT&T.

[33] Verizon Opposition at 25.
[34] *Id.*

Respectfully submitted,

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ATTACHMENT A